CINERGY.
SERVICES

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VIA OVERNIGHT MAIL

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OCT 20 2005
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COMMISSION

October 19, 2005

Ms. Elizabeth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
P.O. Box 615
Frankfort, Kentucky 40602-0615

Re: Joint Application of Duke Energy Corporation, Duke Energy Holding Corp., Deer Acquisition Corp., Cougar Acquisition corp., Cinergy Corp., The Cincinnati Gas & Electric Company and The Union Light, Heat and Power Company for Approval of a Transfer and Acquisition of Control
Case No. 2005-00228

Dear Ms. O'Donnell:

Enclosed please find an original and ten copies of ULH&P's response to the Kentucky Public Service Commission Staff's Hearing Data Request in the above-referenced case.

Please file-stamp and return the two extra copies in the enclosed overnight envelope.

If you have any questions, please call me at (513) 287-3842.

Sincerely,

Anita M. Schafer

Anita M. Schafer
Senior Paralegal

AMS/sew

cc: Hon. Dennis G. Howard, II (via overnight mail with encl.)

KyPSC Hearing Data Request
ULH&P Case No. 2005-00228
Date Received: Oct. 19, 2005
Response Sent: Oct. 19, 2005

KyPSC Hearing DR-01-001

REQUEST:

1. Provide a copy of the Internal Audit Report Cost Allocation Review.

RESPONSE:

Please refer to enclosed Attachment DR-01-001: The Cinergy Services, Inc. Cost Allocation Review Internal Audit Report, January 2005.

WITNESS RESPONSIBLE: Barry F. Blackwell

Cinergy Services, Inc. Cost Allocation Review
Internal Audit Report
January 2005

Table of Contents

Following is the draft Audit Summary for the May 4, 2005 Report to the Audit Committee:

Service Company Cost Allocations

Project Details	Overall Summary	Key Issues	Response
Business Owner(s): Jim Turner, Lynn Good Risk Level: **MEDIUM** *Background*: Cinergy Services, Inc., a subsidiary service company under the Public Utility Holding Company Act ("PUHCA") of 1935, provides services such as accounting, legal, human resources, facilities, etc. to Cinergy Corp. and its utility and nonutility subsidiaries under SEC approved Service Agreements. The PUHCA division of the SEC has recommended that Cinergy perform internal audits of this area every two years. *Scope*: The scope of our review included determining whether procedures and controls related to the cost allocation process are in place and operating effectively and that the cost allocations are in accordance with the Service Agreements.	We did not identify any high-risk control issues surrounding the cost allocation process; however, we identified certain areas where process enhancements could be made.	• Management should determine whether formal SEC approval needs to be obtained for the incentive plan allocation factors.	Management believes that above referenced LEA factors represent ***direct*** allocations of the applicable employee's wages, and as such no further action is required. Management's assertion is based on the fact that the company utilizes the actual pay distributions of the employees in each of the above listed plans to determine the above LEA factors, and as such no new allocation methods have been created. The above LEA's are for administrative efficiencies (i.e., to avoid journalizing each employees incentive payment based on every employee's actual wage distribution for the year) and follow the direct labor assignment as recorded on the employees' labor time tickets of the previous period.

ULH&P Case No. 2005-00228
Attachment
KyPSC Hearing DR-01-001
Page 3 of 13

EXECUTIVE SUMMARY

We have completed the Cinergy Services, Inc. (the Service Company) cost allocation review. The primary objectives of our review were to determine whether procedures and controls related to the cost allocation process are in place and operating effectively and efficiently to minimize risks; and the Service Company allocations are in accordance with the Utility and Nonutility Service Agreements and are fairly and equitably (e.g., in accordance with approved methodologies) allocated to all Cinergy companies including utility and nonutility companies.

Our work included discussions with management and other personnel, review of procedures and controls, and tests of records and supporting documentation.

Following are the recommendations resulting from our review:

- Determine whether SEC approval of the incentive plan allocation basis needs to be obtained via a 60-day letter.
- Continue to educate personnel regarding the types of direct charges allowed to be processed through the Service Company and stress the importance of adhering to these requirements.
- Continue to educate personnel regarding the Code of Federal Regulations' and Service Company's Account 921, Office Supplies and Expense and Account 923, Outside Service Employed accounting rules. In addition, work to identify any reoccurring items charged to Account 921 and 923 in error and adopt process improvements aimed at reducing future reoccurrences.

* * * * * * *

These recommendations along with the accompanying management response are included in the detail issues and recommendation section of this report.

We would like to extend our gratitude to all personnel who assisted us during the review. If you have any questions or need additional information concerning this review, please contact Chad Stone at (513) 287-3170.

The internal audit, from which the accompanying findings and recommendations were derived, was conducted in accordance with Statements on Standards for Consulting Services of the American Institute of Certified Public Accountants. This report has been prepared solely for the use of management and the Board of Directors of Cinergy Corp. In accordance with our engagement letter, this project did not constitute an audit of financial statements in accordance with generally accepted auditing standards.

PricewaterhouseCoopers LLP
Cincinnati, OH
January 12, 2005

OVERVIEW

In 1994, Cinergy Corp. (Cinergy) and Cinergy Services, Inc. (the Service Company), a Cinergy wholly owned subsidiary, were established as a registered holding company and a subsidiary service company, respectively, under the Public Utility Holding Company Act of 1935 (PUHCA). As a subsidiary service company, the Service Company provides services to Cinergy and its utility and nonutility subsidiaries (the Companies) under the Utility Service Agreement dated March 2, 1994 and the Amended Nonutility Service Agreement effective February 18, 1997 (Service Agreements) approved by the Securities and Exchange Commission (SEC) in SEC release no. 35-26146 dated October 21, 1994 and SEC release no. 35-26662-70-8933 dated February 7, 1997, respectively.

Under the Service Agreements, the Service Company provides services such as accounting, legal, human resources, facilities, materials management, information technology, etc. to the Companies at cost and is reimbursed through an intercompany billing and payment process. Service Company costs performed for a specific Company are directly charged to that Company. Costs performed for two or more Companies are assigned to those Companies using an approved allocation basis (e.g., sales ratio, number of employees ratio) included in the Service Agreements or an allocation basis subsequently approved by the SEC. Direct and allocable Legal Entity Allocators (LEAs), which are general ledger system accounting codes, are utilized to assign Service Company costs to the Companies.

OBJECTIVE AND SCOPE OF WORK

The primary objectives of our review were to determine whether:

- Procedures and controls related to the cost allocation process are in place and operating effectively and efficiently to minimize risks; and,
- Service Company allocations are in accordance with the Service Agreements and are fairly and equitably (e.g., in accordance with approved methodologies) allocated to the Companies.

The scope of the review included the following:

- Service Agreements and amendments;
- Establishment, review and revisions to the cost allocation methodologies and legal entity allocations;
- Cost accumulation and allocation procedures and controls (system and manual);
- Direct and allocable LEAs are utilized appropriately;
- Billing procedures in accordance with the Service Agreements; and,
- Management reporting and monitoring.

The audit period for this review was the twelve months ended December 31, 2003 and the eight months ended August 30, 2004 (audit period).

DETAILED ISSUES AND RECOMMENDATIONS

RECOMMENDATION 1: Determine whether SEC approval of the incentive plan allocation basis needs to be obtained via a 60-day letter.

PRIORITY: MEDIUM

Description of issue

Under the PUHCA, allocation methods are required to be formally approved by the SEC Office of Public Utility Regulation. Upon formation of the Service Company, the Service Agreements, which included allocation methods, were approved by the SEC; any new or modified allocation methods are approved by the SEC usually via the 60-day letter request procedure (60-day letter).

The following active Service Company LEAs utilize an incentive plan allocation method that is not included in the Service Agreements or subsequently approved by the SEC:

LEA	Allocation Method
AIP	Previous Year Incentive Dollars - Annual
EMI	Previous Year Incentive Dollars – Energy Merchant
LTP	Previous Year Incentive Dollars – Long Term
NEI	Previous Year Incentive Dollars – Non-Union Employees

Total charges to the LEAs for the twelve months ended December 31, 2003 and the eight months ended August 31, 2004 were approximately $22 million and $39.5 million, respectively.

Risk to Cinergy

Noncompliance with PUHCA and SEC requirements.

Recommendation

We recommend that management determine and document whether SEC approval of the incentive plan allocation basis needs to be obtained via a 60-day letter.

If such approval is needed, a 60 day letter should be submitted to the SEC as soon as possible.

Responsible Department Personnel:
Barry Blackwell, Cost Accounting

Management Action Plan and Date

Management believes that above referenced LEA factors represent ***direct*** allocations of the applicable employee's wages, and as such no further action is required. Management's assertion is based on the fact that the company utilizes the actual pay distributions of the employees in each of the above listed plans to determine the above LEA factors, and as such no new allocation methods have been created.

The above LEA's are for administrative efficiencies (i.e., to avoid journalizing each employees incentive payment based on every employee's actual wage distribution for the year) and follow the direct labor assignment as recorded on the employees' labor time tickets of the previous period.

RECOMMENDATION 2: Continue to educate personnel regarding the types of direct charges allowed to be processed through the Service Company and stress the importance of adhering to these requirements.		**PRIORITY: MEDIUM**
Description of issue	**Risk to Cinergy**	**Recommendation**
Direct charges are those that are 100% allocable to one company. Direct invoice charges are processed through the Service Company using a direct LEA if payment is for a Service Company employee's expenses, services performed by a contractor or a temporary employee performing duties for the Service Company (e.g. services the Service Company would normally provide). In order to reduce the number of direct charges incorrectly processed through the Service Company, Cost Accounting implemented a monthly monitoring procedure whereby a report detailing direct LEA invoice charges for each Client Company is sent to the applicable business unit financial coordinator. The business unit financial coordinator is instructed to review the charges and correct any charges processed through the Service Company in error. Direct invoice charges processed via the accounts payable department for the eight months ended August 31, 2002, 2003 and 2004 were approximately $31 million, $15 million and $23 million, respectively. It appears that opportunities to reduce direct charges processed through the Service Company continue to exist. We selected a sample of 20 vendors with direct charges during the audit period and discussed the nature of the charges with applicable personnel and reviewed invoices and supporting documentation, as needed. It was questionable whether the services or goods provided should have been processed through the Service Company for 9 of the 20 (45%) vendors. In addition, all 9 of the vendors had charges in prior or subsequent months, potentially indicating that the charges were not corrected by the business unit financial coordinator through the monthly monitoring procedure. See Appendix B for details.	Costs are incorrectly processed through the Service Company, potentially resulting in noncompliance with PUHCA and SEC requirements.	Management should review the questionable charges identified in Appendix B in order to determine if these types of charges should be processed through the Service Company. For those charges that should not have been processed through the Service Company, process improvements should be made to ensure that similar vendor charges are not processed through the Service Company in the future. Management should continue to educate personnel regarding the types of direct charges allowed to be processed through the Service Company and stress the importance of adhering to these requirements.

Responsible Department Personnel:	**Management Action Plan and Date:**
Barry Blackwell, Cost Accounting	Management agrees with this recommendation. Cost Accounting will work with the applicable BU financial coordinators to make the necessary process improvements to limit the reoccurrence of these direct accounts payable charges. Additionally, management plans to conduct periodic training updates for all applicable employees.

RECOMMENDATION 3: Continue to educate personnel regarding the CFR and Service Company Account 921, Office Supplies and Expense accounting rules. In addition, work to identify any reoccurring items charged to Account 921 in error and adopt process improvements aimed at reducing future reoccurrences.		PRIORITY: MEDIUM
Description of issue	**Risk to Cinergy**	**Recommendation**
Per the Code of Federal Regulation (CFR), Account 921, Office Supplies and Expenses (Account 921) should include general and administrative expenses of the Service Company such as automobile services, bank messenger and service charges, books, periodicals, subscriptions, building service expenses for customer accounts, sales and administration, communication services, small dollar office equipment, membership fees and dues, office supplies and expenses, payment of court costs, postage printing and stationary, meals, and traveling and incidental expenses. We selected a sample of 20 vendors with charges posted to Account 921 during the audit period and discussed the nature of the charges with cost accounting personnel and reviewed invoices and supporting documentation, as needed. It was questionable whether the services or goods provided should be posted to Account 921 for 7 of the 20 (35%) vendors; 5 of the 7 had charges consistently posted to Account 921 during the audit period. See Appendix C for Details.	Costs are charged to Account 921 in error.	We recommend that Cost Accounting management review the questionable vendor charges identified in Appendix C and determine if the goods or services provided should be charged to Account 921. For those goods or services that should not be charged to Account 921, process improvements should be made to ensure that these types of items are not charged to Account 921 in the future. In addition, management should continue to educate Company personnel regarding the CFR and Service Company Account 921 accounting rules.

Responsible Department Personnel:	**Management Action Plan and Date:**
Barry Blackwell, Cost Accounting	Management agrees with this recommendation. Cost Accounting will work with the applicable BU financial coordinators to make the necessary process improvements to limit the reoccurrence of these incorrect Account 921 charges. Additionally, management plans to conduct periodic training updates for all applicable employees.

RECOMMENDATION 4: Continue to educate Company personnel regarding CFR and Service Company Account 923 accounting rules		**PRIORITY: LOW**
Description of issue	**Risk to Cinergy**	**Recommendation**
Per the Code of Federal Regulation (CFR), Account 923, Outside Services Employed (Account 923) should include fees and expenses of professional consultants such as accountants, auditors, actuaries, appraisers, attorneys, engineering consultants, management consultants, negotiators, public relations, counsel, tax consultants, etc. We selected a sample of 20 vendors with charges posted to Account 923 during the audit period and discussed the nature of the charges with cost accounting personnel and reviewed invoices and supporting documentation, as needed. It was questionable whether the following vendor charge should have been posted to Account 923:	Costs are charged to Account 923 in error.	We recommend that Cost Accounting management review the questionable charges identified and determine if the goods or services provided should be charged to Account 923. For those goods and services that should not be charged to Account 923, process improvements should be made to ensure that these types of items are not charged to the Account 923 in the future. In addition, management should continue to educate Company personnel regarding the CFR and Service Company Account 923 accounting rules.

Vendor/Description	Count	Total Amount ($)
Armstrong's Coffee & Vending	22	32,686

Responsible Department Personnel:	**Management Action Plan and Date:**
Barry Blackwell, Cost Accounting	Management agrees with this recommendation. Cost Accounting will work with the applicable BU financial coordinators to make the necessary process improvements to limit the reoccurrence of these incorrect Account 923 charges. Additionally, management plans to conduct periodic training updates for all applicable employees.

Appendix A – Interview List

During our review we interviewed the following Cinergy personnel:

Barry Blackwell, Director Cost Accounting and External Reporting
Amy Dean, Cost Accounting

Ceci Temple, Paralegal

John Linton, Coordinator, Data Warehouse
Ron Cooley, Senior Analyst

Appendix B – Direct Charges

VENDOR/DESCRIPTION	TOTAL CHARGES ($)	COUNT	REOCCURRING CHARGES to VENDOR
Pantellos Group Limited	2,044,809	140	Yes
SBC Capital Services	2,026,916	280	Yes
Fleet Business Credit, LLC	792,626	19	Yes
McIntyre Brothers, Inc.	622,173	18	Yes
Oracle Corp.	571,757	8	Yes
New Energy Associates	564,913	25	Yes
Nexant, Inc.	429,175	3	Yes
Platts	373,756	11	Yes
Edison Electric Institute	336,319	7	Yes

Appendix C – Account 921, Office Supplies and Expenses

VENDOR/DESCRIPTION	TOTAL CHARGES ($)	COUNT	REOCCURRING CHARGES TO THE VENDOR
Conservation Fund	135,000	1	No
Ducks Unlimited Inc.	122,870	4	Yes
Harvard University	100,000	2	Yes
Power Plan Consultants, Inc.	207,579	6	Yes
Purdue Research Foundation	44,295	3	Yes
The Nature Conservancy	122,075	3	Yes
Triple Point Technology, Inc.	170,833	1	No